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Currency Boards, Depoliticization and Macroeconomic Stability:

The Political Economy of Institutional Complementarities¹

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Abstract

This article analyzes the potential for institutional design to depoliticize macroeconomic policy-making by examining currency board arrangements. It develops a novel argument to understand the effects of institutional design based on institutional complementarities. This argument highlights that the functioning of a given institution is conditioned by the broader institutional context. The article contrasts this framework with two common approaches – here termed the institutional design and the epiphenomenalism views – and argues that the centrality of institutional complementarities can account for the mixed record of currency boards. The most important complementarities of a currency board are with fiscal, labor market and informal institutions, which are important prerequisites for successful currency boards. By drawing on recent advances in the study of depoliticization, we show how these institutions contribute to governmental, societal and discursive depoliticization. This argument is evaluated by examining three case studies of currency boards – Argentina, Estonia and Lithuania. The article also explores some broader implications of this analysis for understanding the depoliticization of economic policy.

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Introduction

One of the key concerns in both scholarly and policy debates about economic policy relates to the role of institutions in preventing macroeconomic instability. There has been extensive research by economists and political scientists on the role of institutional design in both developed and developing countries. Much of this debate has revolved around central bank independence as a way of depoliticizing monetary policy and eliminating time inconsistency problems (Persson and Tabellini 1993).

By contrast, this article focuses on currency boards, a particular form of fixed exchange rate regime, in which money in circulation is fully backed by the central bank's foreign currency reserves.² Currency boards were at one point quite common, especially in British colonies in the early 20th century. As colonies gained independence, they generally moved away from such monetary policy arrangements. More recently, currency boards have experienced a renaissance of sorts. After Hong Kong reinstated its currency board in 1983 following almost a decade under a more flexible exchange rate regime, a number of countries also introduced them – Argentina (1991), Estonia (1992), Lithuania (1994), Bulgaria (1997), Bosnia-Herzegovina (1997), adding to a list which also includes some long-standing currency boards, including Brunei, Bermuda and the Faroe Islands (Williamson 1995).

In light of various developing country financial crises, there has been growing interest in currency boards as a particularly hard peg. Along with dollarization and currency unions, currency boards are seen to constitute one of the 'corner solutions' that, unlike ordinary fixed exchange rate regimes, could be expected to withstand speculative attacks on global financial markets (Fischer 2001). Currency boards remain controversial, and this controversy is largely bound up with different theoretical perspectives on institutions.

This article contrasts two broad approaches to economic institutions, here labelled the 'institutional design' and 'epiphenomenalism' views, with an alternative framework based on institutionalist scholarship. We integrate insights from institutionalist scholarship to make four contributions.

First, we develop a more nuanced account of currency board regimes and their sustainability. By drawing on recent institutionalist scholarship, we argue that institutional complementarities can explain why the effects of currency boards are not uniform. In particular, we argue that the sustainability of a currency board cannot be taken for granted. We suggest that other institutions condition the effects of currency boards. If complementary institutions exist, then the currency board is likely to be stable and perform well. However, if

² Strict adherence to currency board criteria would rule out conventional central banking and any attempts by the monetary authority to engage in sterilization or other form of intervention in financial markets. Since none of the modern currency boards have fully respected these restrictions, Hanke (2002) prefers to refer to them as currency board-like regimes. This paper follows conventional practice and simply uses the term currency board (Williamson 1995).

the broader institutional framework is not complementary, then a currency board will not be sustainable.

Second, our case studies shed light on the determinants of such complementarities. This is potentially quite significant, given that the sustainability of currency boards may depend on them. Critics of existing scholarship on institutional complementarities have argued that their political underpinnings are underspecified or based on functionalist assumptions (Streeck 2005). Unless a currency board is introduced in an economy that already has complementary institutions, it could still be successful, provided that the currency board can become an anchor or focal point stimulating the subsequent development of complementary institutions, e.g. in a newly independent country without well-established institutions, like Estonia.

Third, based on this analysis of institutional complementarities and currency boards, we reflect on the scope for institutional design to bring about depoliticization of economic policy, by removing a policy area from the remit of political contestation. Here we draw on recent debates about the need to broaden the concept of depoliticization beyond state-centric approaches and consider societal and discursive dimensions (Wood and Flinders 2014). While this research has highlighted the importance of interactions between different forms of depoliticization, our article suggests that such interactions can be understood as a form of institutional complementarities.

Finally, we reflect on the lessons of this analysis for understanding the relationship of successful currency boards to economic crises. Our article implies that this relationship is complex. On the one hand, economic success in terms of growth and low inflation increases the support for currency boards. To some extent fiscal prudence and the accumulation of surpluses in good times may also enhance the authorities' ability to withstand crises. On the other hand, we note that even successful currency boards with highly complementary institutions and a strong commitment to fiscal prudence, like that in Estonia, may experience deep recessions, in part because the very success of the currency board may contribute to excessive optimism, credit growth and higher private borrowing. Most importantly, for the currency board to withstand a severe crisis, complementary institutions and an exceptionally strong political commitment to the currency board are essential, as it is under such circumstances that sustainability is most severely tested.

In the following section, we introduce the theoretical debate. After that we analyze the currency boards in Argentina, Estonia and Lithuania and examine the role of complementary institutions in contributing to their sustainability. The conclusion identifies some general lessons for the debate about institutional design, institutional complementarities, currency boards and depoliticization.

Institutions, currency boards and depoliticization of economic policy

Most advocates of currency boards, especially in economics, subscribe to what we call an ‘institutional design’ perspective. According to this perspective, policy makers can craft institutions, and assuming that they are carefully designed and the associated rules are followed, they can be expected to deliver good results. The introduction of central bank independence is an example of institutional design that is expected to lead to lower inflation (Persson and Tabellini 1993; Alesina and Summers 1993). However, other kinds of institutional design, such as the adoption of fixed exchange rate regimes, have also received attention and been quite common, both in Europe and in emerging markets (Uribe 1997; Schamis and Way 2003).

From the institutional design perspective currency boards represent a superior way of depoliticizing monetary policy, reining in fiscal policy and ensuring macroeconomic stability (Hanke 2002). According to Hanke (2002), the currency boards that have failed have fallen short because the principles of genuine currency boards were not implemented. More generally, this perspective relates to debates about depoliticization, which have been increasingly influential in recent years as governments have sought to overcome time inconsistency and other regulatory problems by designing institutions that minimize the scope for political influence and contestation in various policy spheres (Flinders and Buller 2006).

By contrast, sceptics tend to view currency boards as epiphenomenal, as any good outcomes associated with currency boards reflect other underlying factors (Roubini 1998). In other words, if institutions are endogenous and reflect other factors, such as the interests of the powerful, then they may not have any independent causal effect of their own (Przeworski 2004, 166), in much the same way as many realists in international relations theory perceive institutions (see Mearsheimer 1994). If there is a correlation between currency boards and good macroeconomic outcomes, then this is because a strong preference for macroeconomic stability induces both the adoption of the currency board and good economic outcomes – and these factors would be likely to produce good macroeconomic outcomes even without a currency board (Roubini 1998; see Posen 1998 for a similar argument about central bank independence).

We suggest that neither of these two perspectives can account for the empirical record of currency boards. The epiphenomenalism view cannot fully account for the robust relationship between the introduction of currency boards and falling inflation (Wolf et al. 2008), whereas the institutional design view cannot explain why some currency boards, like Argentina's, which were initially viewed as successful, ultimately collapsed or why countries like those in the Baltic states, which were strongly committed to currency boards, experienced some of the deepest recessions in the world in 2008-9. This also reinforces the need to understand the factors contributing to the sustainability of institutions.

This article seeks to reconcile the contradictory experiences of currency boards by developing an alternative approach that draws on the insights of institutionalist scholarship. Institutionalists define institutions as ‘humanly devised rules and procedures—both formal and informal—that constrain and enable political behavior’ (Levitsky and Murillo 2004,

117). Building on Hall and Thelen (2009) and others, we also see institutional continuity and change as a political problem, i.e. something that cannot be taken for granted, but which has to be actively created and maintained by political actors, especially in times of economic crises.

This article focuses specifically on the importance of institutional complementarities, which imply that the ‘functional performance of an institution A is conditioned by the presence of another institution B, and vice versa.’ (Höpner 2005, 383; see also Aoki 1994 and 2001). If such institutional complementarities are important, then the functioning of currency boards cannot be assessed in the abstract without considering other related institutions. Institutionalist scholars have shown that institutional complementarities are important in various fields of the political economy, e.g. the complementarity of corporate governance and industrial relations (Höpner 2005) and of central bank institutions and labor market institutions (Iversen 1999; Soskice and Iversen 2000). This idea is also one of the central building blocks of the Varieties of Capitalism approach (Hall and Soskice 2001). More recently, research in a similar vein has considered the differential effects of currency unions on countries with different types of labor market institutions. Such research has compared Northern and Southern Eurozone members (such as Germany and Greece), and shown that the institutional context in Germany is very well suited to the Economic and Monetary Union (EMU), whereas the Greek economy fares less well, given that it lacks coordinated wage-setting institutions and has traditionally been more reliant on devaluations to restore competitiveness (Hancké 2013; Hall 2014). Since many policies are endogenous to various institutions and their desirability is context-dependent, the institutional environment is very important.

We consider three kinds of institutions, corresponding to the three forms of depoliticization identified by Wood and Flinders (2014): governmental, societal and discursive depoliticization. First, as a form of governmental depoliticization, i.e. the design of government institutions to minimize political contestation, we consider fiscal institutions. There is a consensus in the literature that fiscal policy plays an important role under a currency board (Wolf et al. 2008; Williamson 1995). High deficits may lead to a depletion of foreign currency reserves, which could ultimately undermine the currency board regime. Similarly, fiscal surpluses in good times are an important prerequisite for responding to economic downturns, as activist monetary policy cannot be used under a currency board. The literature on fiscal policy has demonstrated that fiscal institutions are important determinants of fiscal policy outcomes. Based on the existing literature we expect the centralization of fiscal policy making, budgeting procedures and the degree to which sub-national governments face hard budget constraints to have an important impact on deficits and to make the sustainability of currency boards more likely (Eslava 2006).

Second, we also consider societal depoliticization, i.e. the degree to which there is public debate on a given issue. Here civic engagement and the structure of civil society are particularly important, given that this is generally the foundation of public engagement and active debate about policy (Wood and Flinders 2014, 159). In this context, we examine labor market institutions, as trade unions are among the most important civil society organizations

that seek to influence economic policy. Much of the literature on currency boards and currency unions has focused on the importance of labor market flexibility, especially during economic downturns, since the currency board regime precludes competitiveness restoration with nominal exchange rate depreciation. However, labor market institutions also shape the sustainability of currency boards in other ways. Most importantly, organized labor may act as a veto player for economic policy or help repoliticize economic policy-making, for example, by arguing for a broader remit of economic policy. We also consider constitutional arrangements, including the federal/unitary structure of countries, as they are also likely to affect the representation of cleavages and the degree of policy contestation (Tsebelis 1995). This literature also includes studies of electoral systems, which shape the representation of specific interests and the number of veto players (Persson and Tabellini 2004). We pay less attention to this factor, given that there is limited variation across our cases with respect to this variable. While Lithuania has a mixed system, all the cases considered here have considerable elements of proportional representation in national legislative elections.

Third, we also consider discursive depoliticization, ‘when the debate surrounding an issue becomes technocratic, managerial, or disciplined towards a single goal’ (Wood and Flinders 2014, 161). Such dominant understandings manifest themselves as informal institutions or norms, which constrain behavior and shape preferences by means of a logic of appropriateness (March and Olsen 2006). We explore whether there is any evidence of informal norms strengthening these currency boards. We expect high legitimacy and taken-for-grantedness to contribute to the sustainability of currency boards. By contrast, contestation surrounding economic policy or lack of confidence in formal institutions may make currency boards harder to sustain (Levitsky and Murillo 2004).

In addition, these case studies explore the determinants of institutional complementarities. As part of the debate surrounding dollarization and the validity of the optimum currency area criteria, some observers have argued that it would be dangerous to enter a currency union if all of the criteria were not fully satisfied. By contrast, others have argued that there could be an element of endogeneity and that once the new currency was in existence, the relevant institutions, trade flows and business cycles would adjust (for an overview, see Eichengreen 2002; de Grauwe 2000). As it is generally acknowledged that institutional complementarities do not result from deliberate grand designs (Thelen 2004, 285), this article explores under what circumstances such complementarities may emerge, even if they do not exist when the currency board is introduced.

Case selection

This article adopts a comparative case study design to the study of currency boards. Case studies are a very useful approach to this kind of research, as they allow us to analyze institutions and related causal mechanisms in great detail (George and Bennett 2005). Our case selection is based on the ‘diverse case method’, which ‘requires the selection of a set of cases—at minimum, two—which are intended to represent the full range of values characterizing X, Y, or some particular X/Y relationship’. (Seawright and Gerring 2008, 300). By examining three currency boards, Argentina, Estonia and Lithuania, we are able to

analyze the role of complementary institutions in reinforcing or weakening the currency board.

All of these currency boards were introduced to facilitate stabilization. Argentina had a long history of high inflation, and there were several failed stabilization attempts in the 1980s. Partly harking back to a previous era of prosperity when there was also a currency board (1899-1929), Argentina introduced a currency board in 1991 to bring down inflation. While it was initially perceived to be very successful, the Argentine case also represents the most famous example of a currency board's collapse, as it unraveled in 2001-2.

Estonia and Lithuania regained their independence from the Soviet Union in the early 1990s and introduced currency boards in the midst of a dramatic transition from central planning to market economies. Estonia introduced the currency board along with the new national currency, the kroon, in 1992, and Lithuania introduced its currency board about two years later. These two countries maintained their currency boards for about twenty years until adopting the euro in 2011 and 2015 respectively.

This article demonstrates that the three currency boards considered here vary with respect to the nature of complementary institutions that emerged over time, with complementarity ranging from high (Estonia), intermediate (Lithuania) to low (Argentina) (see Table 1 for an overview of key patterns). We demonstrate how these complementarities affected the viability of the currency board regimes in these three countries.

TABLE 1 ABOUT HERE

Argentina

For a number of years after its adoption, the Argentine currency board was viewed as very successful in taming inflation, restoring macroeconomic stability and ensuring robust growth, and the IMF characterized Argentina as a great success story. Argentina's quick rebound from the 'Tequila' shock of 1995 also added to the currency board's popularity (Wolf 2008, 122). Concerns about financial stability after that crisis also contributed to reform of the financial system, which arguably became increasingly compatible with the currency board, and the privatization, consolidation and internationalization reforms in the second half of the 1990s were widely viewed as successful (De la Torre, Yeyati, and Schmukler 2003, 49).

We argue that the ultimate collapse of the currency board demonstrates that Argentina is a good example of a political economy without key institutional complementarities necessary to underpin it. In particular, although the central government did attempt to contain public spending, especially during the final years of the currency board regime, fiscal profligacy ultimately undermined the currency board regime. In contrast to Estonia, Argentina on average ran a sizeable public deficit during the years of the currency board's operation despite high economic growth rates throughout most of the 1990s (see Table 1). On this dimension, Argentina is similar to Lithuania. As demonstrated in Table 1, the average

public deficit was even higher in Lithuania, but as discussed below, the main difference between these two countries pertains to Lithuania's greater ability to adjust during economic crises.

Although federalism is sometimes 'market-preserving' and may contribute to fiscal prudence and generate smaller deficits (Rodden and Wibbels 2002; Weingast 1995), in Argentina's federal system the principle of revenue sharing exacerbated common pool problems in fiscal policy, not least given persistent inter-regional conflicts. This made it difficult to impose hard budget constraints on provincial governments, as the central government had to finance some provincial spending (Blustein 2005, 47-53; Rodden and Wibbels 2002, 504). The Minister of the Economy Domingo Cavallo (2002) recounts in detail how problems in sharing the fiscal burden during the crisis of 1998-2002 contributed to the downfall of the currency board regime. There have been frequent attempts to reform fiscal policy institutions. Tax legislation was enacted or modified over 80 times in the period 1988-2008, but the political integration of national parties fell, thereby increasing the importance of sub-national leaders and weakening the central government's ability to enforce budget balance (Bonvecchi 2010, 2).

Another reason why the currency board arrangement proved hard to sustain was its lack of compatibility with Argentine labor markets. Labor market regulations had remained rather rigid despite several steps towards increasing flexibility in the first half of 1990s (Patroni 2001). Organized labor has been an important political actor, in part given the close ties to the Peronist Justicialist party (PJ), an important force in Argentine politics. Strong mobilization by organized labor as a key social actor has often served as a veto point in Argentine politics and contributed to its 'conflict society', as well as growing unrest and resistance to the currency board during the deepening economic crisis after 1999 (Baer et al. 2002).

Informal norms were not conducive to the sustainability of the currency board. Key principles of economic policy, including the appropriate emphasis on macroeconomic stability, have been controversial in Argentina, and the traditional strength of developmentalist and heterodox ideas can explain the lack of a strong consensus on economic norms underpinning the currency board (Sikkink 1988, Neiburg 2006). As noted above, the failure of the stabilization programs in the 1980s also illustrate a tradition of unsuccessful macroeconomic reform strategies and reversals. More generally, Argentina is widely perceived as characterized by institutional weakness. Although lifetime tenure of Supreme Court justices has been enshrined in the constitution since 1853, practically all Argentine (democratic and non-democratic) governments have packed the court with preferred appointees (Levitsky and Murillo 2004, 116). Such factors are likely to have weakened the prospects for the sustainability of any formal institutions, including macroeconomic institutions, like the currency board.

The initial success of the currency board regime and the stability of the financial sector also had complex effects. It encouraged extensive borrowing in foreign currency (in US dollars in Argentina's case). In the short term this strengthened the currency board, by increasing domestic demand and growth and by creating powerful constituents for preserving

the peg as devaluation would have immediately increased the real value of debt (Woodruff 2005). However, the perceived success of financial reform and of the currency board regime itself grew into over-optimism. Enthusiastic assessments by the IMF and American financial institutions tended to discount the risks of adverse developments and boosted lending to Argentina (Blustein 2005). This led to considerable increases in both private and public debt, which ultimately contributed to undermining the currency board itself (Wolf et al. 2008, 139).

These problems and the consequences of the lack of institutional complementarities became increasingly obvious as Argentina was hit by crisis after 1999. Given that fiscal policy had been loose during the 1990s, the government had to borrow money to service the existing debt, and there was no scope for countercyclical spending in the depth of the recession. In light of the common pool problems discussed above, it was very difficult to constrain fiscal spending and to agree how to distribute the costs of very substantial adjustment between the central government and the provinces. The relatively rigid labor markets also increased the costs of adjustment in terms of unemployment. Many business groups started showing dissatisfaction with the currency board regime (Steinberg 2008, 27-30). Exporters and import-competers revealed their frustration with lack of competitiveness, while non-tradable representatives were unhappy because of contracting domestic demand and deflation. Only the banking sector remained unequivocally in support of the currency board regime (Steinberg 2008, 27).

Therefore, the Argentine experience illustrates the hazards of introducing a currency board into a political economy without complementary institutions. While the government was hoping that the currency board might contribute to fiscal prudence and contain debt, the most important lesson from the Argentine case is that institutional complementarities cannot be created simply by introducing a currency board. If the root cause of inflation is fiscal profligacy and common pool problems in taxation and spending, then credible fiscal reform is necessary to address this problem. If this does not materialize, then a currency board can be self-defeating, not least by inducing a false sense of security and facilitating more borrowing to address competing claims in society (Baer et al. 2002), while the lack of complementary institutions means that the currency board could not be maintained during the crisis.

Estonia

The Estonian experience differs from Argentina's in several respects. Given that Estonia was undergoing an economic transformation when the currency board was introduced, the country did not have any well-established complementary economic institutions. However, highly complementary institutions subsequently emerged, and this underpinned the commitment to the currency board and fiscal prudence for the duration of the currency board.

Although there has been some variation over time (including some loosening during the boom years), Estonia has had one of the most prudent fiscal regimes in Europe since the early 1990s. There were budget surpluses during nine of the eighteen years that the currency board was in existence (Feldmann 2013, 357; see also Table 1). As a result, Estonia has the

lowest consolidated debt-to-GDP ratio in the European Union, which stood at 10% in 2013, well below the EU average of 87.1%.

This is largely attributable to complementarities with key fiscal institutions. Estonian fiscal policy-making is highly centralized. Budget commitments are generally agreed by the cabinet as a whole (Raudla 2013). The cabinet has also been able to bypass parliament on some issues, e.g. by deciding not to incur some agreed expenditures at the implementation stage (Raudla 2013). Article 116 of the Estonian Constitution, which states that any public spending needs to be financed by corresponding revenues, is sometimes described as a balanced budget requirement, but it is more accurate to see it as a quasi-constitutional norm that politicians have felt obliged to respect (see Raudla and Kattel 2011). In comparative terms policy-making is also facilitated by the fact that Estonia has a very small unitary state with relatively few veto players in policy-making, and local governments face hard budget constraints. More recently, and especially during the economic crisis in 2008-9, the institutional complementarities were important factors contributing to the maintenance of the currency board despite a deep economic crisis. The centralized fiscal policy institutions and relatively flexible labor markets facilitated the strategy of internal devaluation.

It is also likely that the widespread awareness that large fiscal deficits might undermine the currency board has moderated pressures for increases in public spending. There is some evidence to suggest that the early introduction of the currency board had direct effects on fiscal institutions. For example, Raudla (2010, 473) shows that the constraints imposed by the currency board influenced the design of budgeting procedures from the early 1990s, which have gradually developed into a fiscal contracts model of centralized fiscal policy-making. This is significant given that Estonia has had multi-party coalition governments and a fragmented party system since the first parliamentary election in 1992 (largely as a result of its proportional representation electoral system), which could have been expected to make it harder to achieve fiscal consolidation and balanced budgets (Eslava 2006).

Another important complementarity relates to labor market institutions. The Estonian labor markets are comparatively flexible, which has made wage adjustments in response to shocks somewhat easier in Estonia than elsewhere in Europe (Dabušinskas and Rõõm 2011). This has also strengthened the belief of Estonian experts in the feasibility of internal devaluation, i.e. adjustment without a devaluation of the exchange rate, even as foreign experts were skeptical or cautioned against it (Feldmann 2013). Labor market flexibility has also been reinforced by the political weakness of organized labor. Estonian trade unions have very low levels of membership (see Table 1), and to the extent that they have disagreed with government policy, they have not generally been able to mount any significant challenges to it.

The currency board was also underpinned by informal institutions and norms. The endorsement of the currency board arguably goes beyond economic outcomes and includes a symbolic dimension, as the kroon increasingly came to be seen as a symbol of Estonian independence and successful economic reforms and growth (Feldmann 2008; Lauristin and

Vihalemm 1997). Tellingly, a businessman who was advocating currency devaluation during the last economic crisis stated that ‘Estonian kroon must be untied from national flag, the national anthem and the coat of arms, and it should be viewed as a financial instrument – or we will end with bankruptcy’ (Tere 2012). This strong symbolic commitment to the currency board meant that it also enjoyed widespread popular support. Most Estonians associated the currency board with successful disinflation and the stabilization of the currency in the 1990s, thereby contributing to discursive depoliticization (Wood and Flinders, 2014). While the logic of the currency board was initially poorly understood even by economists, and many politicians and members of the public were skeptical or even opposed to it (Hansson 1994), the expert community and general public gradually came to support the peg with only minor exceptions (e.g., Kattel 2009). This commitment was largely maintained during the financial crisis of 2008-9 and has effectively been embraced both by the political right – which has been a dominant force in Estonian politics – and the political left. When there have been disagreements about fiscal policy, as between the center-right Reform and Fatherland-Res Publica Parties on the one hand and the center-left Social Democrats on the other in the summer of 2009, these have tended to revolve around the composition of fiscal spending or around the level or progressivity of taxation, not around the principle of balanced budgets per se. There have not been any significant political or popular challenges to these policies, and this was also true during the most recent economic crisis protests in Estonia were very limited, even compared to other countries in the region, such as neighboring Latvia (Beissinger and Sasse 2014).

How did such norms take hold? In part, this relates to the fall in inflation and resumption of growth in the 1990s and the perception of the currency board as an anchor of stability e.g. during the Russian crisis of 1998. The smallness and openness of the Estonian economy have also contributed to widespread support for stable exchange rates. Several factors could explain the support for the regime by sectors that theoretically might have opposed it. First, support for the currency board arrangement grew as a result of borrowing in foreign currency. For instance, the largest Estonian company Tallink, a logistics operator, had considerable loans in euros during the 2008-09 crisis (AS Tallink 2009, 3), as did many other businesses and households. Therefore, a stable exchange rate underpinned by the currency board was perceived as a way of avoiding difficulties of servicing these debts. Second, as in Lithuania, businesses appreciated macroeconomic stability and the overall very liberal economic regime, of which the currency board system was one of the chief anchors. Third, the strong ideational consensus in favor of the currency board discouraged opposition to it. Fourth, during the most recent crisis retention of the currency board was also bound up with the strategic objective of euro adoption, which was widely seen as important to consolidating Estonia’s position at the core of the EU and enhancing the country’s security (Feldmann 2013, 365). Finally, businesses found it relatively easy to adjust to competitiveness challenges because of the structural and institutional characteristics of Estonian economy and polity. As might be expected, the banking sector and the non-tradables sector – the traditional advocates of hard currency – have been unanimously in favor of the currency board system. It should also be noted that key characteristics of the financial sector were conducive to the operation of the currency board. While there was some turbulence in the Estonian banking sector in the

1990s (most notably during the banking crisis in 1992 and to a smaller extent in conjunction with some bankruptcies in 1998), since the turn of the century the Estonian banking sector has been dominated by foreign ownership (99.2% of the banking sector was foreign-owned by 2005 (Darvas and Pisani-Ferry 2008, 2). For instance, during the last crisis in 2008-09, overall stability was bolstered by the fact that no bank rescue was needed (Epstein 2014), which reduced the pressure on public finances during the crisis.

Lithuania

Lithuania's institutional framework could be classified as displaying intermediate levels of complementarity to the currency board compared to the other cases. As in Estonia, the currency board was introduced during the transition process that Lithuania was undergoing after regaining independence from the Soviet Union. While it did affect institutional development and acquire an important symbolic status, Lithuania did not develop equally complementary fiscal institutions; furthermore the consensus in favor of the currency board strengthened later than in Estonia. This may be related to the fact that Lithuania introduced the currency board later than Estonia, and therefore it may have played slightly less of a coordinating role for institutional development.

In contrast to Estonia, Lithuania has not displayed strong fiscal discipline, at least during times of economic growth (see Table 1). Fiscal policy was expansionary both before the Russian crisis and before the Great Recession. During the period of operation of the currency board, there was not a single year in which Lithuania had a budget surplus.

As noted above, we classify Lithuania as displaying intermediate levels of complementarities in terms of fiscal institutions. On the one hand, Lithuania lagged behind Estonia and the Central and Eastern European average in terms of establishing budgetary rules conducive to fiscal discipline, as shown by Hallerberg and Yläoutinen (2010). Specifically, while Lithuania caught up with Estonia and regional average in terms of rules fostering the 'delegation' approach by early 2000s, it was still lagging regarding rules for the 'contracts' approach in 2007 (the literature considers 'contract' rules to be more important for countries like Estonia and Lithuania which tend to have multi-party coalition governments (Hallerberg and Yläoutinen 2010). Unlike Estonia, the norm of fiscal discipline did not emerge in Lithuania, as the considerable deficits during the boom years illustrate (see Table 1). This was characteristic of governments with parties both on the political left and right.

On the other hand, Lithuania's fiscal policy making is highly centralized, and there are few informal constraints. Therefore, Lithuania's majority governments have found it relatively easy to implement extensive fiscal policy adjustment during downturns, including both the 1998-1999 and especially the 2008-2010 crises when considerable fiscal consolidation packages were implemented. Overall, enforcement of the fiscal 'leg' of the currency board regime has been asymmetric: lack of enforcement during boom years (when constraints loosened) but very strict enforcement during crises. During economic downturns the preservation of the peg and the whole currency board system was one of the motivating

factors for pursuing dramatic fiscal consolidation. This was especially evident during the crisis in 2008-2010. Political leaders publicly justified the need for fiscal consolidation by arguing that this was necessary to escape currency devaluation. Lithuania did not apply for official IMF assistance, and one of the reasons for this was the fear of the 'Argentina scenario' in reference to the neighboring Latvia where, as the then Deputy Chairman of Parliament's Finance and Budget Committee claimed, the IMF had pressed for currency devaluation (*Kaunodiena.lt* 2008).

There is also some evidence that the currency board had an independent effect on fiscal policy in Lithuania (Kropas and Šidlauskas 2002, 71). During the early years of the currency board's operation, there were attempts by the government to monetize deficits, but they were successfully resisted (Nausėda 2004). As early as 1997, Gitanas Nausėda, who was a high-ranking official at the central bank at the time, suggested politicians 'forgot that the central bank can be forced to implement inflationary or deflationary monetary policy' (Nausėda 1997, 9). Before the introduction of the currency board in 1994, the governor of the central bank was changed three times in less than four years. After the currency board was established, there were only two changes in twenty years. Monetary and currency policies gradually became stable and increasingly depoliticized in Lithuania, which suggests that the currency board did have some effect on institutional development. However, the currency board was also destabilizing in that it indirectly contributed to laxer fiscal constraints via its positive effects on confidence, interest rates, and the economic boom that ensued. As in Estonia, there was considerable overheating in the run-up to the global downturn of 2007-9.

Labor market institutions have been complementary to the currency board. The flexibility of the labor market has facilitated adjustment to shocks and the maintenance of the currency board regime. Lithuanian businesses have generally not expressed dissatisfaction with the currency board, which could partly be explained by the fact that they could increase competitiveness via other means, such as high wage flexibility (for which businesses were lobbying intensively) as well as lower tax rates. During the boom years and overvaluation periods, Lithuanian businesses oriented themselves towards the lucrative domestic market, and during downturns they were able to reorient towards external markets. This flexibility is also related to trade union weakness (see Table 1). The lack of enforcement of labor market regulations in Lithuania (as well as Estonia) also substantially increased the flexibility of the labor market (Eamets and Masso 2005). As there are no traditions of social pacts or wage coordination and trade unions are very weak, there are fewer constraints on policy and less contestation.

In terms of informal institutions and norms, Lithuania can also be viewed as being in an intermediate position. Unlike Estonia, Lithuania did not develop any strong norm supporting fiscal surpluses, and there was great controversy surrounding the introduction of the currency board. There were also specific government proposals to abandon the currency board in the second half of the 1990s. On the other hand, the currency board regime has enjoyed great support at least since the early 2000s, and its introduction has been widely perceived as one of the most successful decisions during Lithuania's recent economic history (Kuodis 2008, 10). The normative commitment to it was very strong by the time the last crisis

struck in 2008-09, and hardly any analyst or economist mentioned the possibility of ending the currency board arrangement. Given that currency and monetary regimes were constructed during the transition period along with restoration of national state institutions, the currency board regime also became a powerful national symbol as in Estonia (Feldmann 2008) or a fact of economic life which was almost never questioned. For example, whenever anyone mentioned the possibility of abandoning the currency board regime during the economic crisis in 2008-10, they were considered incompetent or even unpatriotic. A prominent politician who discussed related issues publicly was subsequently ridiculed in the media and harshly criticized by the main political parties (*Klaipēda* 2009), which indicates high discursive depoliticization of the currency board. Such a strong and unquestioning commitment to the currency board contributed to rendering the large adjustment program during the financial crisis of 2008-10 possible. As in the Estonian case, a devaluation or abandonment of the currency board might also have jeopardized the prospect of euro adoption, which successive governments were strongly committed to.

In addition to increasing support for the currency board, this success had contradictory effects. On the one hand, by promoting macroeconomic stability and higher confidence, it contributed to increasing indebtedness (private and public), which led to higher vulnerability and greater susceptibility to crises. On the other hand, borrowing in foreign currency created powerful lock-in effects via ensuring greater support for the peg. A variety of complementary institutions helped ensure the viability of the currency board and facilitate the dramatic adjustment policies that were needed to maintain it during economic downturns.

Conclusions

This paper has applied insights from institutionalist scholarship to the study of currency boards. While currency boards are not a panacea, they may foster macroeconomic stability and be strong institutions in many cases. Existing scholarship focusing on differences in the suitability and effects of currency boards across countries has tended to focus primarily on economic factors, such as the size of the economy, trade patterns and vulnerabilities to external and internal shocks (Williamson 1995), whereas this paper has put greater emphasis on the institutional prerequisites of currency boards and explored their sustainability and contributions to depoliticizing macroeconomic policy.

First, we have argued that currency boards cannot be assessed in the abstract and stressed the importance of complementary institutions to the stability of currency boards, notably fiscal, labor and informal institutions, such as norms. In the absence of such an institutional environment, currency boards are less likely to be maintained, as the Argentine experience illustrates. In Argentina common pool problems in fiscal policy helped undermine the currency board, and relatively rigid labor markets and distributional conflicts involving both organized labor and provinces meant that adjustment under the currency board was difficult, even when there was a strong political commitment by the central government. The key fiscal institutions we have stressed are centralized fiscal policy-making, limited veto-players as well as specific fiscal rules, which have been present in Estonia in particular. The Lithuanian case has been in an intermediate position, in that centralized fiscal policy has been

very responsive in times of crisis, but less so in boom times. In addition, we have suggested that informal institutions may also be complementary to a currency board, as a strong normative consensus of the kind found in Estonia and increasingly also in Lithuania strengthened it, by contributing to discursive depoliticization and making alternatives to the currency board almost unthinkable in these two countries. It is noteworthy that in many ways the Baltic situation during the downturn of 2008-10 was less favorable than the one in Argentina in 1998-2001; Estonia and Lithuania experienced faster and more dramatic falls in GDP and exports and arguably faced worse global economic conditions but, unlike Argentina, managed to keep their currency board regimes intact (Kuokštis 2013).

Second, the Baltic cases show that currency boards may be helpful, especially in new institutional environments that initially lack complementary institutions. The Estonian case suggests that establishing a currency board in a newly independent country can be successful, especially if the currency board becomes an anchor shaping the development of other institutions, including those related to fiscal policy. In Lithuania, the currency board was introduced later and did not lead to the adoption of equally tight fiscal policy, though it ultimately became an important anchor of economic policy. Both cases illustrate that a currency board may serve as a focal point for institutional development and also be underpinned by norms, which may contribute to societal and even discursive depoliticization of the currency board and undermine challenges to it (see Raudla and Kattel 2011).

Third, this analysis has potentially profound implications for debates surrounding institutional design to depoliticize economic policy-making. To the extent that the functioning of institutions depends on a web of complementarities, institutional design is unlikely to have the desired effect unless it also affects and reshapes complementary institutions. Estonia and Lithuania were newly independent and small unitary states with centralized policy-making, where the currency boards acquired a central status and influenced other socio-economic institutions. The Argentine case is a cautionary tale and demonstrates that this may not necessarily occur everywhere, especially if there is pervasive contestation over relative gains within society (Baer et al. 2002). Therefore, we are skeptical about the prospects of currency boards in many emerging market economies, like Russia and Indonesia (Culp, Hanke, and Miller 1999). Our argument could extend to depoliticization in other areas of economic policy-making, such as regulatory or tax policy, where institutional complementarities may also be crucial to the sustainability and ultimately the success of institutional reforms.

Finally, we have also shown that currency boards are related to economic crises in complex ways. Successful currency boards have contradictory effects. On the one hand, successful disinflation, macroeconomic stabilization and maintenance of the currency board during a crisis help increase support for this kind of monetary policy regime. On the other hand, by tying the hands of policy-makers, successful currency boards enhance credibility and thus loosen constraints on fiscal policy, which can lead to the lack of fiscal discipline which it was designed to prevent in the first place. This can also fuel extensive private borrowing, as in Argentina, Lithuania and even in Estonia, where a financial crisis erupted in 2008-9 despite sound public finances. Furthermore, currency boards tend to lead to real

exchange rate appreciation, which causes both aggregate economic problems and potential political pressure from specific interest groups, especially if the overall institutional environment in the country precludes flexible adjustment. This means that even successful currency boards are not inoculated against crises, and the sustainability of a currency board in the face of a crisis cannot be taken for granted.

The broader policy implications of our analysis suggest that currency boards may sometimes be successful, but they are no panacea and involve considerable risks. Most importantly, the depoliticization of macroeconomic policy is only likely to be successful, if there are complementary institutions in place. If such complementary institutions do not exist when reforms are undertaken, their subsequent emergence cannot be taken for granted. Our article suggests that future research on institutional design should pay more attention to institutional complementarities and their development, including the politics of fiscal and labor market institutions, but also informal institutions and norms given the importance of the societal and discursive dimensions of depoliticization, which are likely to be underpinned by complex political processes.

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Table 1. The currency boards in Estonia, Lithuania, and Argentina.

	Argentina	Estonia	Lithuania
CB start/end	1991, March/ 2002, January	1992, June 20/ 2011, January 1 [euro adoption]	1994, April 1/ 2015, January 1 [euro adoption]
Years of operation	11	19	21
Average annual real GDP growth, in percent	3.9	2.1 (4.0 if 1992-93 excluded)	3.8
Complementarity of fiscal institutions (governmental depoliticization)	Low	High	Medium
Average annual public surplus/deficit, in percent of GDP	-2.4	0.2	-3.2
Min and max of annual public surplus/deficit, in percent of GDP	-6.1 (2001) 0.0 (1993)	-3.6 (1999) 2.9 (1997)	-9.4 (2009) 4.2 (1996)
Average annual current account surplus/deficit, in percent of GDP	-3.0	-6.7	-6.3
Min and max of annual current account balance, in percent of GDP	-4.8 (1998) -0.23 (1991)	-16.0 (2007) 3.9 (1992)	-14.5 (2007) 4.0 (2009)
Average annual gross public debt, in percent of GDP	38.8	5.7	25.7
Max annual gross public debt, in percent of GDP	53.6 (2001)	9.0 (1995)	41.0 (2012)
Complementarity of labor institutions (societal depoliticization)	Low	High	High
Union density rate, 2001	42.0	13.5 (2002)	16.8
Union density rate, 2012	30.0	6.5	9.0
Complementarity of informal institutions (discursive depoliticization)	Low	High	Medium-High

Sources: World Bank database; IMF World Economic outlook database; Wolf et al.; EBRD Transition Reports; ICTWSS (AIAS) database; authors' analysis and calculations.